

Impact on Rural Telephone/Nex-Tech of the FCC Order on USF/ICC Reform April 2012

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Our Company At A Glance

- 25,512 Voice Access lines
- 19,420 Broadband Customers – began offering in 1998
- 11,859 Video Customers
- 27,467 Long Distance Customers
- 8,736 Number of Business Lines Served
- 257 Number of Anchor Institutions* Served
- 70%+ Broadband Adoption Rate
- 370 Employees
- 9,307 Service Area in Square Miles

* Schools, Public Libraries, Hospitals and Public Safety entities

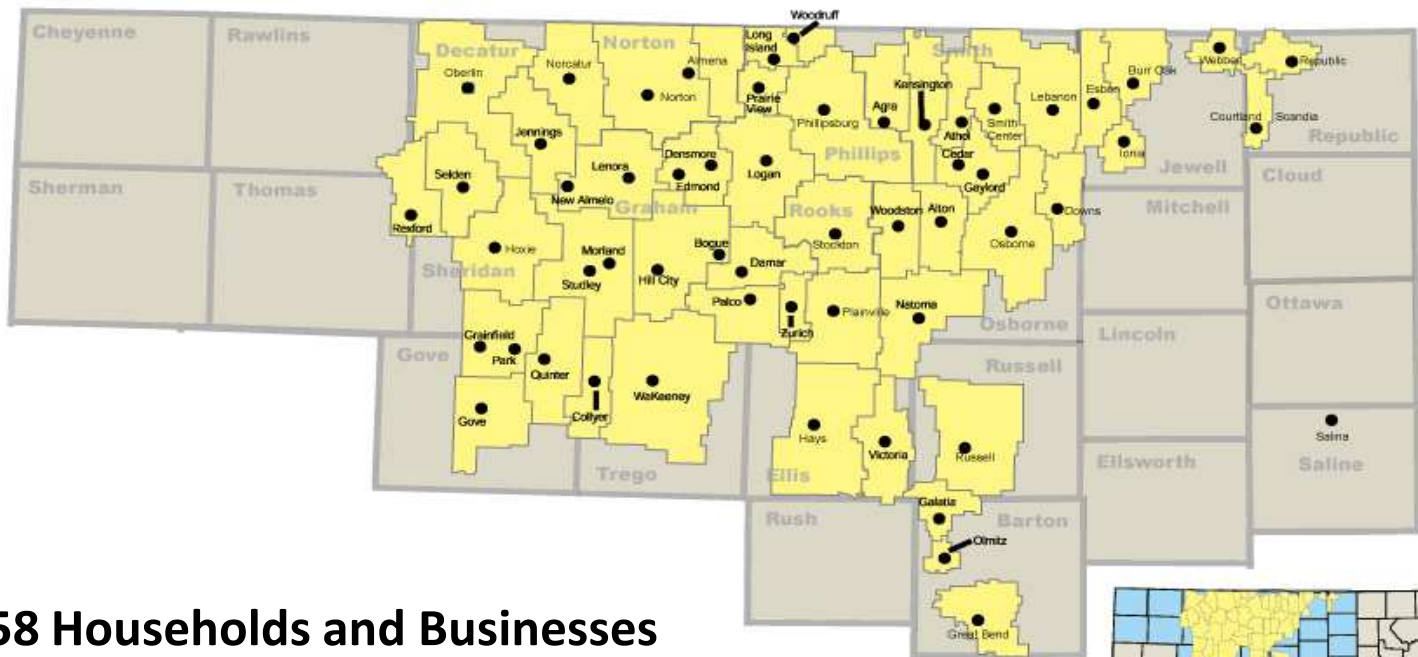
Transitioning Western Kansas to Broadband

- Began providing broadband in 1998
- In 2006, acquired 10 rural exchanges from Sprint
 - These exchanges were 99% unserved with broadband
 - Borrowed \$55 million from RUS, along with internal equity funds to build 100% broadband capable plant; 13 year note
 - Achieved 70% broadband take rate which created economic development opportunities, jobs, and brought young people back to western Kansas
- In 2009, President Obama announced the ARRA Program
 - Applied for and received \$101 million, including \$51 million loan funds through RUS; 12 year notes
 - RUS required a financial feasibility to ensure viability and the project was deemed feasible and approved

Transitioning Western Kansas to Broadband

- Followed policies and procedures under the guidance and specifications of RUS in building the broadband network
- Achieved over 70% broadband take rate in the communities and rural areas
- Upon completion of the stimulus build projected 1st quarter 2013, broadband services will be available to over 9,300 square miles in rural, remote areas of western Kansas

Broadband Coverage



- 39,158 Households and Businesses
- 76 Towns & surrounding rural areas
- 9,307 Square Miles
- 11% of Kansas

Transitioning Western Kansas to Broadband

Free Broadband & Wi-Fi Connection to Every Library in Our Footprint

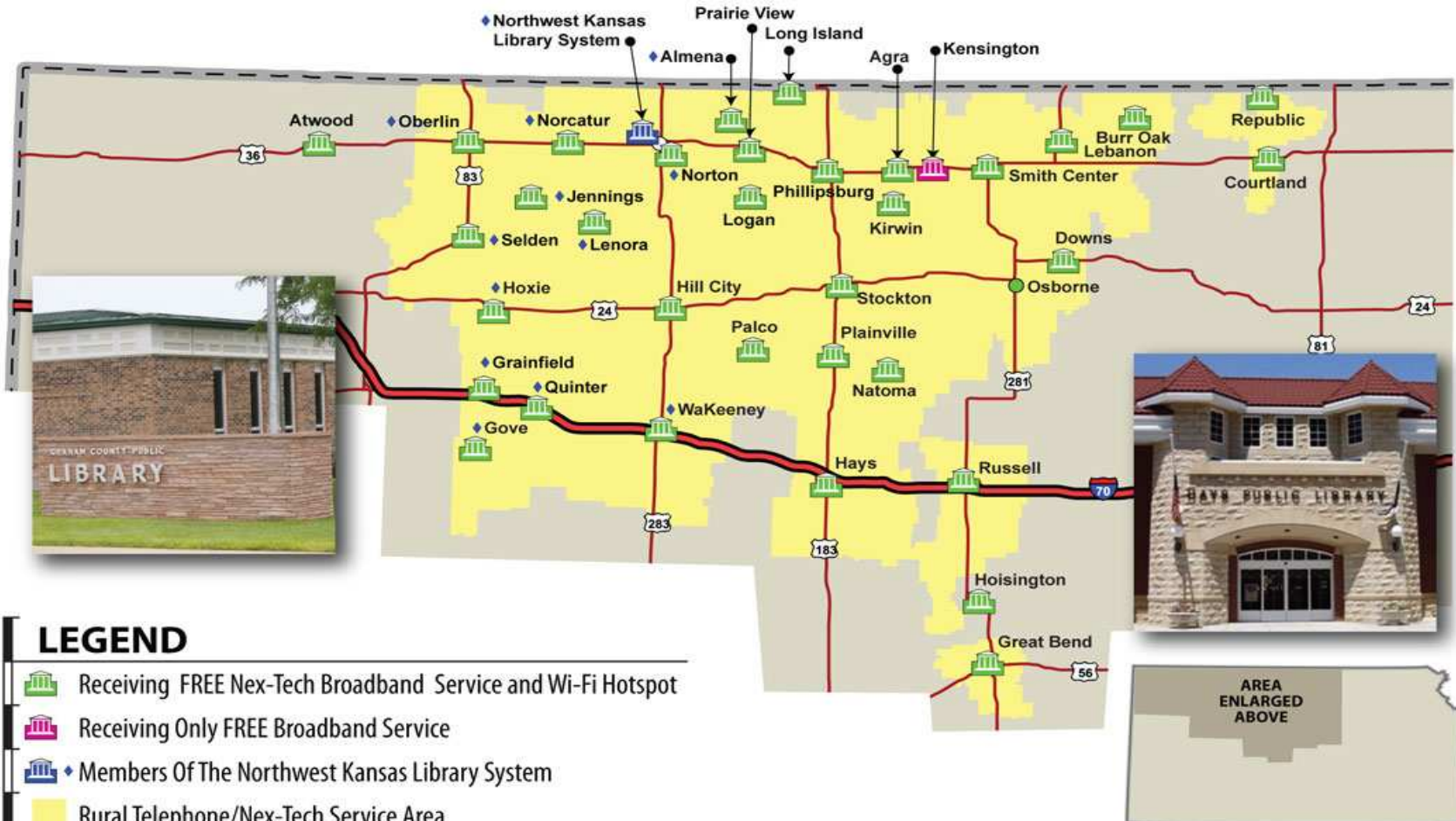
- The President's initiative to create jobs and bring broadband to unserved and underserved rural areas was followed
- Broadband access is vital to level the playing field for small, rural communities to compete in today's fast-paced, technology-driven society
- Providing free public-access Wi-Fi connections is critical in order to ensure that every individual in our area —regardless of income—has access to these essential services
 - Average Median Income is \$28,023; Average Median Age is 43
- To ensure that everyone has access to the Internet, free broadband and Wi-Fi services are provided to every library (37) in our footprint

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Libraries Map



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“The Good Life”

Article from the Salina Journal



†Newspaper articles from Salina Journal
Reporter Tim Unruh
Photo by Jeff Cooper

Young people and their families are returning to Courtland, Kansas.† The young adults all agree that technology was essential to their return. “The thing that made it possible was connectivity,” Tanner Johnson said. “The service available in Courtland is faster than what was offered in Norman [Oklahoma],” he said. Mike Johnson calls it telecommuting. “I know a lot of people work at home. They’re starting to realize they can work anywhere,” he said.

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Broadband, Continually Evolving

- In the FCC Order, the FCC goal for rural broadband is 4 Mbps down, 1 Mbps up - this is totally inadequate as more than 30% of our existing customers already have speeds exceeding this goal
- During the past 12 months, our number of broadband customers with 6 Mbps or higher services tripled
- Today, we serve over 6,400 broadband customers who require higher than 4 Mbps bandwidth, of which over 500 of these customers require 10 Mbps to 75 Mbps
- We are projected to outgrow our 10 Gig network in 2012 based on demand, yet the FCC Order and Regression model does not allow for any improvements to our backbone network
- Projected costs to upgrade our backbone network from 10 Gig to 20 Gig is \$4.6 million

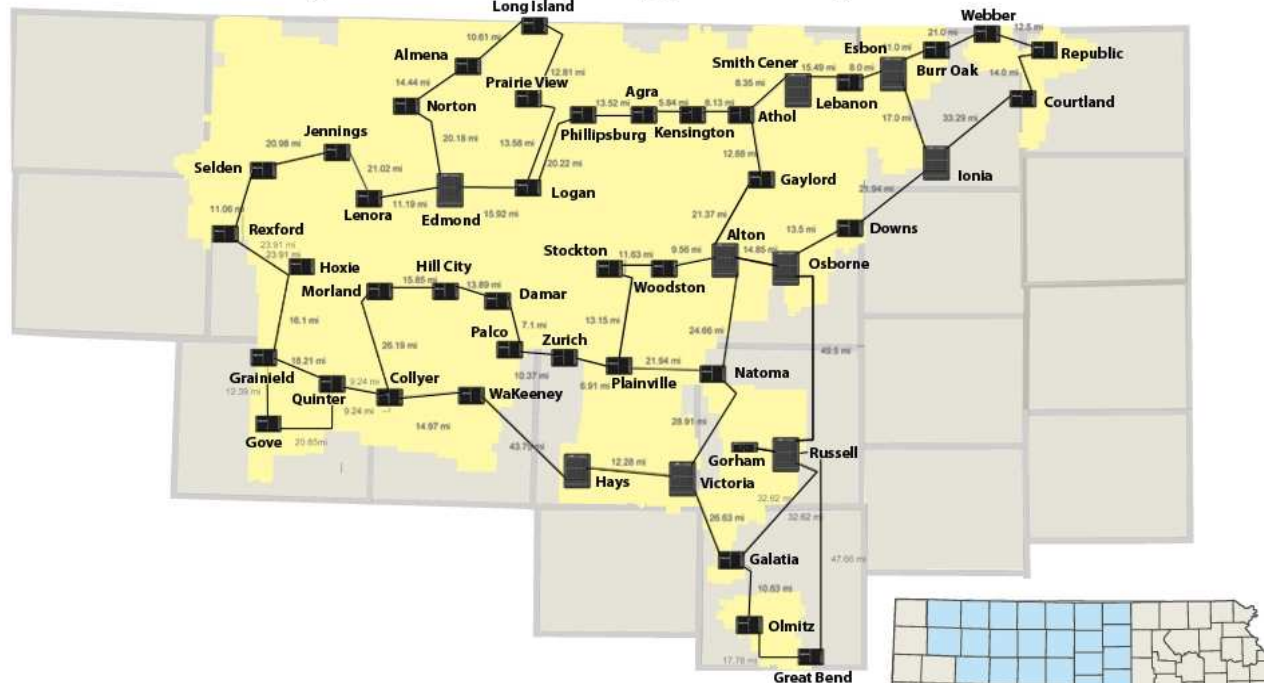
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10 Gig Transport Network

Rural Telephone 10 Gig Transport Network



- Miles across territory east to west: 171 miles
- Miles across territory north to south: 118 miles
- Number of network nodes: 48 nodes
- Total miles of transport network: 936 miles

Wireless Broadband requires Wireline

- Fact - wireless service will not work in much of western Kansas without our fiber network
- We provide 369 circuits to 120 wireless towers utilized by all the major nationwide wireless carriers
- By the end of 2012, nearly all of these towers are expected to have more than 4 Mbps connectivity and more than 20 tower sites will have 50 Mbps connectivity
- Review Tower Map

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FCC Order: USF/ICC Reform

- The FCC Order changes the rules on which all prior investment decisions were based and will penalize our company for investing in broadband capable facilities in rural Kansas
- The capping mechanism appears to include companies' data that have not built broadband capable networks, and excessively penalizes companies who serve large land masses with low population density and long loops
- Network configurations are ignored
- Prudent and reasonable broadband investments were made, following RUS engineering standards and system design, prior to the effective date of the FCC Order, and complying with the regulatory rules in effect at the time
- We will now be limited retroactively on the recovery of capital investment and operating expenses
- Retroactive "after the fact" ratemaking places our company in the impossible situation of being unable to recover past capital investment and operating expenses related to previously incurred costs
- The proposed regression methodology is the most financially harmful aspect of the FCC Order impacting our company
- The regression methodology has major flaws and should be rejected

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FCC Order/FNPRM Impact

\$182,244	Loss of Safety Net Additive Support
\$13,835	Loss of switched access revenue requirement (5% reduction)
\$4,516,686	Loss of HCL Support based on proposed regression caps; cumulative loss of \$56,118,111 through 2020
+++++	+++++
\$2,827,423	**Loss of ICLS Support based on proposed regression caps

** This is estimated based on the current regression schedule. This reduction is not included in our attached financial forecast.

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Targeted Investments and Expenses

Devastating Reductions to Recovery of Specific Network and Operating Expenses

90th Quantile

(\$1,253,727)

Capped Costs

Cable and Wire Facility Expenses

(\$1,518,129)

Central Office Equipment Expenses, including Depreciation

(\$2,120,685)

Network Operations & Circuit Expenses

(\$1,169,828)

Benefits

(\$465,255)

Other

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Targeted Investments and Expenses – Cable & Wire Facilities

- Investment in fiber and electronics in our transport network and FTTP to meet RUS requirements and increasing customer demands
 - Technicians drove an average of 1,382,096 miles per year for the past five years to service our customers; 84% of the roads in our service area are unpaved requiring 4-wheel drive maintenance vehicles which operate at a higher cost than average
 - Maintain over 6,500 route miles of fiber and copper plant, along with over 780 miles of subscriber drop cable, with 1.6 customers per route mile
 - Construction season is 6 to 7 months, requiring overtime in order to get projects built and cutover
 - Completed 8,036 service orders, 7,375 maintenance tickets and 9,949 locates in 2011
 - \$101 million ARRA BIP project is subject to the requirements of the Davis Bacon Act
 - Required changing our payroll from bi-weekly to weekly
 - Compliance with wage rates set by the Department of Labor
 - Numerous additional reporting requirements

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Targeted Investments/Expenses - Central Office/Circuit Equipment

- Transitioning to a broadband company over the last ten years due to customer demand
 - Reduced central office switching investment by collapsing 39 switches into two soft switches
 - Completed an average of 107 central office/network upgrade jobs per year for the past five years
 - Installed an average of 293 new circuits per year for the past five years
 - Ordered/provisioned an average of 24,276 pieces of central office/network equipment per year for the past five years

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Targeted Investments/Expenses

Central Office / Circuit Equipment

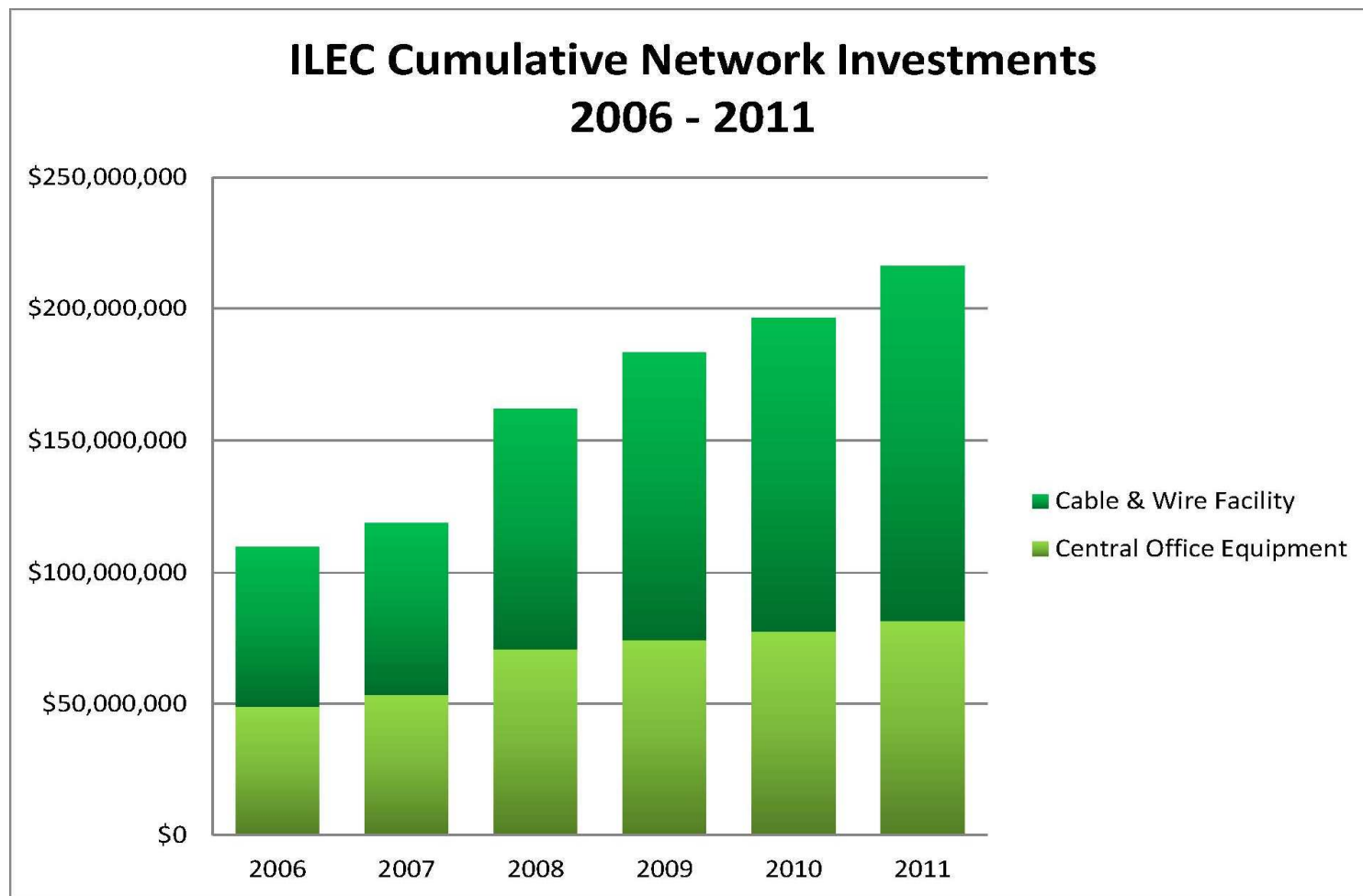
- Broadband adoption efforts resulting in over 70% penetration rates
 - Over 3,800 ILEC customers currently subscribe to higher than 6 Mbps broadband
- Investment in network due to bandwidth demands
 - Projected to outgrow our 10 gig network by the end of 2012
 - During the past 12 months, our number of broadband customers for 6 Mbps or higher services tripled
 - Cisco predicts the average fixed broadband speed to quadruple—from 7 Mbps to 28 Mbps—by 2015; the average broadband speed has already doubled within the past year from 3.5 Mbps to 7 Mbps
 - During the past 12 months, wireless backhaul circuits have increased by 85% as wireless carriers prepare for 4G — this growth will continue as many additional circuits are being quoted for multiple carriers
 - Third-party video and gaming services now account for more than 20% of our Internet traffic
- Investment in 24 hour network operations center to help manage costs of large geographic area
 - NOC handled 1,975 total tickets in 2011; 900 were major, 62 critical

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Targeted Investments and Expenses



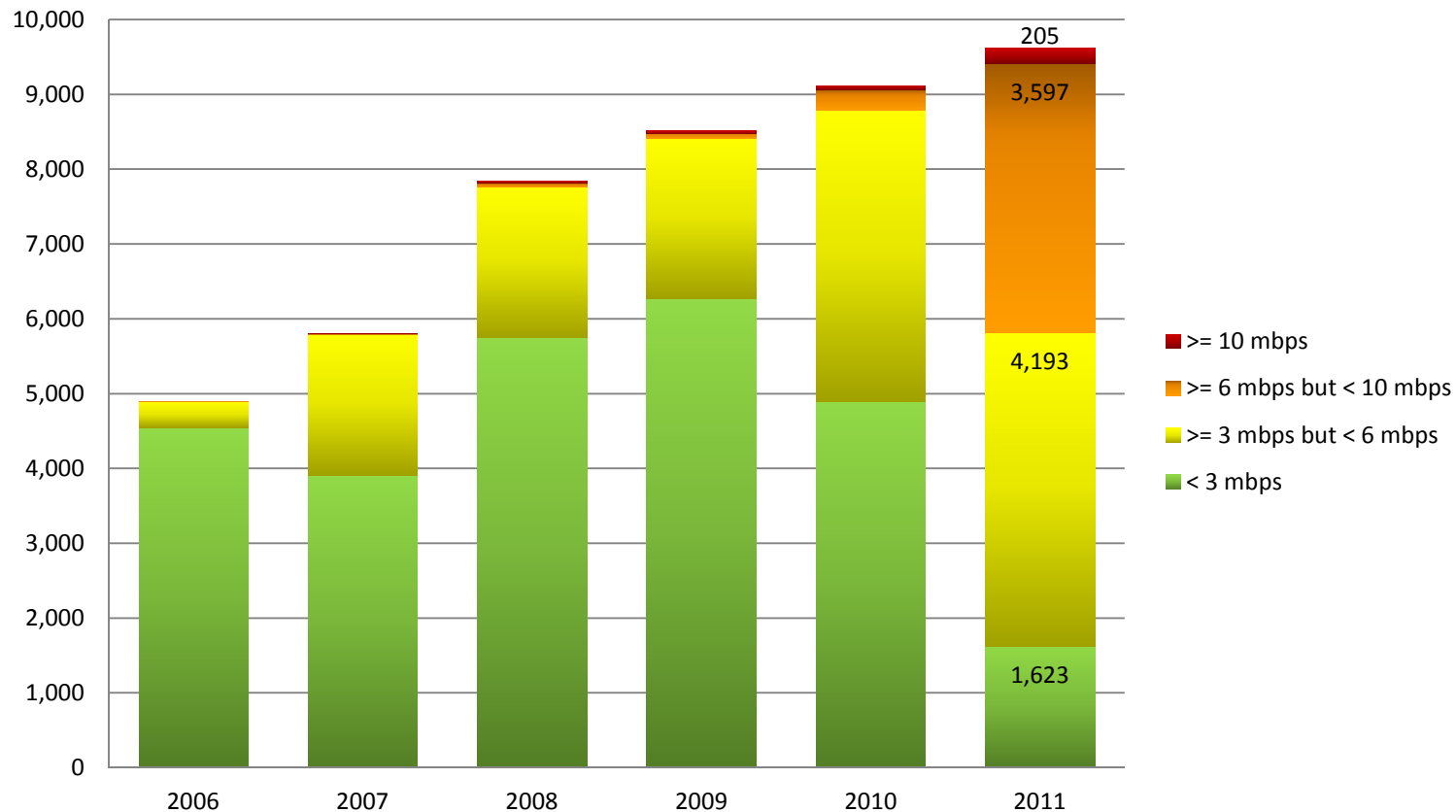
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Targeted Investments and Expenses

ILEC Broadband Subscribers By Speed
2006 - 2011



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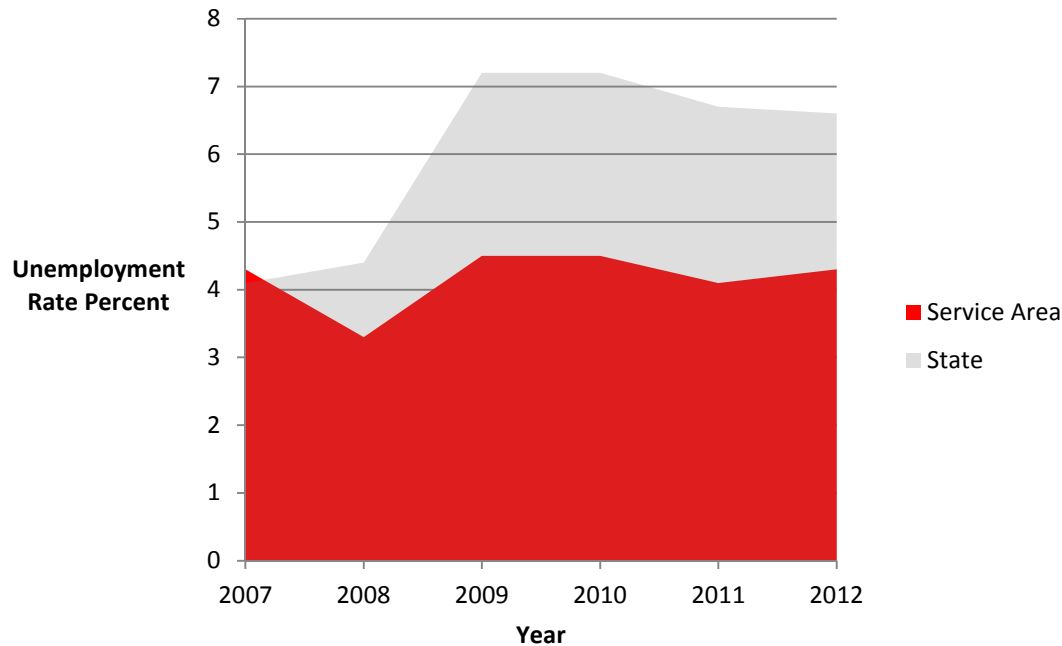
Targeted Investments and Expenses - Benefits

- Benefits costs are necessary to attract talented employees and keep employee churn low
 - We need good benefits (health insurance) to be able to attract employees to our very remote, rural area
 - Saved over \$15 million by self-funding our health insurance plan over the past five years, saving us over \$500 per month per employee
 - 100 miles to nearest shopping mall; very limited social life; very difficult to attract young people from outside the area
 - We need good benefits (retirement) to retain employees
 - See unemployment chart for our geographical area; if we lose employees we do not have a large local pool to draw from
 - See historical employee turnover chart for our company

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Unemployment & Turnover Rates

Unemployment Rates



Our Company Employee Turnover Rates

	Year	Turn Over %	
	2008	6%	
	2009	7%	
	2010	8%	
	2011	7%	

Quantile Regression Analysis Failures

- **Failure Point #1: Independent Variables**

- Variables used have poor correlation and poor predictive capability to costs
 - Many costs have no correlating variable for density or terrain and are essentially calculated as “per loop” amounts
 - 42% to 92% of the changes in costs are unexplained by the QRA
- Census blocks is a poor proxy for population density
 - Contains 600 to 3,000 people and differs greatly by region
- No variables effectively capture the effect of loop length, terrain, or other cost causers
 - Unpaved roads and other factors more telling than % water

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Quantile Regression Analysis Failures

- **Failure Point #2: Comparison Assumptions**

- Uses costs of companies with little or no broadband to determine “appropriate” levels of broadband investment.
- Companies in comparison are not “similarly situated”.
 - 46 companies between 7,000 and 10,000 access lines

Demographic	Average	Rural Tel Svc Co
Access Lines	8,326	8,433 (20 th)
Service Area (sq mi)	1,799.35	6,390.78 (4 th)
Census Blocks	2,457	10,599 (2 nd)

- **Failure Point #3: Reasonable and Necessary Costs**

- No determination if costs are used and useful or necessary
- How could our network be engineered more efficiently?

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ILEC Debt Service to RUS

* REDACTED *

Bullet Points

* REDACTED *
Debt Chart

* REDACTED *
Margin Projections

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Rural Telephone Service Company, Inc.
Financial Forecast 2012 - 2020 - REDACTED

									4/6/2012
Income Statement	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenues									
End User Revenues	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Universal Support Revenues	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Access Revenues	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Miscellaneous Revenues	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Total Revenue	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Total Expenses	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Net Income / (Loss)	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Balance Sheet	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Assets	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Cash Flow Statement	2012	2013	2014	2015	2016	2017	2018	2019	2020
Net Margin Plus Depreciation	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Plant Capital Investments	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Long Term Debt Principal Payments	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Net Increase / (Decrease) in Cash	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Beginning Cash Balance	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *
Ending Cash	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *	* REDACTED *

Summary of Broadband Success

- For more than 15 years, our company has invested millions of dollars in building broadband infrastructure
- At the encouragement of the President, we recently invested \$101 million dollars through the ARRA Broadband Initiatives Program to bring broadband infrastructure to rural areas that historically had insufficient broadband service
- In the process, we created jobs and strengthened the economy to promote the survival of these remote, rural areas
- We have been audited by the KCC, RUS, NECA, and twice by USAC, and they found no fraud, waste or abuse
- We are under the cap on maximum USF allowed per working loop

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Summary Impact of the Order / FNPRM

- The FCC Order and FNPRM appears to contradict the directive of the President and the Administration and is penalizing rural LECs who have built broadband
- The effect on economic viability of rural areas in Kansas and across the nation will be devastating; growing demand for high capacity applications requires fixed facilities in rural areas to deliver “reasonably comparable” service
- An economic impact study prepared by the Docking Institute of Public Affairs showed the five year negative impact of the Order and FNPRM to be a loss of over 200 jobs and nearly \$40 million in economic activity for our area alone
- The retroactive nature of the FCC Order and FNPRM takes away the financial feasibility for rural LECs across the nation to continue to maintain and advance services and to invest in broadband

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What We Are Doing

- We met with the FCC in July 2011 to explain the negative impacts of the proposed rules on USF/ICC Reform
- We submitted comments in January 2012 to the FCC explaining our concerns with the FCC Order and its potential devastating impacts to rural areas
- We recently testified before the Kansas House Standing Committee on Energy and Utilities and addressed the negative impacts the FCC Order will have on rural Kansas
- We met with Kansas Corporation Commission (KCC) staff and discussed our concerns with the FCC Order and the adverse financial effect to our company
- We have joined more than 100 rural ILEC's in filing a petition for review of the USF/ICC Order; the 10th Circuit Court of Appeals in Denver will hear the consolidated cases
- We met with RUS officials to discuss our concerns regarding the impacts of the FCC's Order and share our revised financial forecasts
- We are preparing to seek waiver of rules limiting reimbursable capital and operating costs if the Wireline Competition Bureau adopts the proposed quantile regression methodology for HCLS and/or ICLS

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What the FCC Can Do

- Stop any further effort on additional reductions in USF and ICC support until implications of the reforms and reductions adopted in the Order can be evaluated and understood
- Ensure that lawfully incurred investments and operating expenses are not jeopardized by retroactive rule changes
- Ensure that investments and expenses that have been made in accordance with federal agency standards and mandates will not be deemed unlawful, imprudent or not “used and useful”
- Adopt a clear-cut and non-burdensome waiver mechanism that will allow cost recovery for investments made in accordance with federal agency standards and mandates
- Adopt a sustainable and predictable broadband oriented Connect America Fund for rural LECs that allows for continued expansion of broadband service in rural areas

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